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NO. 507

IN THE

Supreme Court of the United States

October Term, 1969

BAY SOUND TRANSPORTATION CO., et al.,
Petitioners

v.

UNITED STATES OF AMERICA, *Respondent*

PETITION FOR WRIT OF CERTIORARI
To The United States Court Of Appeals For The Fifth Circuit

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UNITED STATES OF AMERICA, *Respondent*

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To The United States Court Of Appeals
For The Fifth Circuit

To the Honorable, the Chief Justice and the Associate Justices of the Supreme Court of the United States:

Petitioners, Bay Sound Transportation Co., et al., pray that a writ of certiorari issue to review the decision of the United States Court of Appeals for the Fifth Circuit rendered April 30, 1969.

OPINIONS BELOW

An opinion rendered by the United States District Court for the Southern District of Texas, Houston Division, is not officially reported. It is unofficially reported

at 67-2 USTC ¶9641. (It appears in the printed record on pages 1537-1614.)

The opinion of the Court of Appeals for the Fifth Circuit was entered on April 30, 1969. It has not yet been officially published. It is unofficially reported at 69-1 USTC ¶9371. (Petitioners' Motion for Rehearing was denied without opinion.)

JURISDICTION

The United States District Court had jurisdiction of this case under 28 U.S.C. §1291.

The judgment of the Court of Appeals was entered on April 30, 1969, and the order overruling the Appellants' Motion for Rehearing was entered on May 30, 1969. The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

QUESTIONS PRESENTED

1. *Separate-Corporations Issue.* Whether, on the record, the taxpayer-corporations were created for "the principal purpose" of avoidance of federal income tax, under Section 269 of the Internal Revenue Code.

2. *Depreciation Issue.* Whether no depreciation write-off over a period of (a) less than 20 years for tugboat hulls, (b) less than 15 years for barge hulls, would have been "reasonable," within the meaning of Section 167 of the Internal Revenue Code.

STATUTES INVOLVED

The applicable statutes, Sections 167 and 269 of the Internal Revenue Code, are set out in the Appendix. *infra.*

STATEMENT OF THE CASE

1. *Separate Corporations ("Multiple-corporations") Issue.*

By an overwhelming preponderance of the evidence, and with no evidence to the contrary, the taxpayers showed that the "principal purpose" for the creation of the separate taxpayer-corporations was to limit liability, not to avoid taxes. The District Court, thinking that if tax avoidance was merely one purpose of forming the corporations their separate surtax exemptions must be disallowed, held for the Government under Section 1551 of the Internal Revenue Code. But Section 1551 was not applicable, as the Court of Appeals held. The Court of Appeals reversed and remanded to the District Court for it "to determine whether or not the findings of fact on the record are sufficient to disallow the exemptions of the surtax under Section 269."

It is our position that as a matter of law the record requires the conclusion that the "principal purpose" for forming the corporations was not tax avoidance. A contrary conclusion would be "clearly erroneous." *Southeastern Canteen Co. v. Commissioner*, (9th Cir., decided May 13, 1969), ___F.2d___ (69-1 USTC ¶9396), reversing the trial court and rendering final judgment on this issue.[1]

This is the strongest case for upholding the separate surtax exemptions of separate related corporations that we have run across.

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1. See also, to the same effect (under a different statute), *W. Braun Co. v. Commissioner*, 396 F.2d 264 (2d Cir., 1968).

The taxpayer corporations' business consisted of transporting petroleum (a "live bomb"), in crowded waterways. One could compare it to driving a butane truck down a crowded highway without brakes.

As if this were not enough, the taxpayers were predominantly self-insured. Not to operate as separate corporations would seem foolhardy, from a strictly business standpoint, under such circumstances, because otherwise one accident by one vessel would have subjected the entire fleet to liability.

The evidence from many unrelated witnesses established that it is customary procedure in the industry to have separate corporations for the purpose of limiting exposure to liability.[2]

The taxpayers' attorneys advised that admiralty trends and awards were increasingly favoring claimants, and therefore that separate corporations should be formed to keep liability exposure within bounds.

There was no evidence to the contrary.

The District Court found that the principal individual connected with the taxpayers (Mr. C. W. Edwards) had been advised by admiralty attorneys to have separate corporations in order to isolate liability; before these separate corporations were formed. (Finding No. 54,

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2. Indeed, for other industries too, separate surtax exemptions for related corporations seems to be the rule rather than the exception. A report of the Internal Revenue Service for the year 1964 shows that approximately 182,000 tax returns were filed by affiliated corporations in "controlled groups" and that the majority of these (104,000 corporations) elected separate surtax exemptions. See 26 Journal of Taxation 147 (March 1967). This rebuts any contention that recognition (for tax purposes) of the taxpayers as separate entities would give them unfair advantage over others.

citing Tr. 1137-38.) Also, in Finding No. 55, the trial court found that some of the taxpayer corporations and their vessels were not covered by personal-injury or property-damage insurance.

The District Court eroneously placed a "heavy" burden on the taxpayers,—the correct burden being the normal preponderance-of-the-evidence standard.

The District Court thought the amount of claims in relation to the amount of tax savings to be a relevant consideration. However, in listing claims (Finding No. 56), the District Court listed only claims against *barges*. Claims against the barges *and tugboats* totaled several millions of dollars. (See Appendix 0 to the "Brief for the Appellants" in the Fifth Circuit.) Moreover, the District Court erroneously assumed the amount of tax savings to be $110,000, whereas, in reality, that was only the maximum potential tax savings and the actual tax savings were shown to have been considerably less. Indeed, for the first taxable year involved (1957), the taxpayers suffered a net loss because of operating through more than one corporation, and the next two years their net over-all tax saving through separate corporations amounted to $16,632 in 1958 and $6,114 in 1959, according to later computations made by the taxpayers (see Appendix P of said Brief). Thus, the District Court was wrong in saying (R. 1590) that "the separate corporations resulted in a savings of about $110,000 per year." In 1959, out of the 20 corporations, only 7 had substantial income, while 10 had substantial losses.

In the instant case, the Government conceded that limiting liability may have been one of the purposes for having separate corporations.

The comparable case of *Tidewater Hulls, Inc. v. United States,* 68-1 USTC ¶9405 (E.D. La., 1968), was decided by the trial court against the Government, and the Government did not appeal. There the court held that, even if Section 1551 were applicable, the taxpayers had established that tax avoidance was not even a "major purpose," let alone the "principal purpose," of the formation of separate related corporations. That case is not nearly as strong a case for the taxpayers as the present one. That this is so was stated in the Government's own brief in the *Tidewater* case, which also reads in part as follows:

> the only evidence * * * [of tax avoidance in the *Bay Sound* case] was that the individuals involved were made aware of the tax consequences * * *.

The *Government* concluded in its brief in *Tidewater:*

> The absence of such evidence ["clear and express evidence" of "tax avoidance motives"] in *Bay Sound* undoubtedly prevented the application of Section 269.

2. *Depreciation Issue.*

The depreciation issue basically is whether the taxpayers' investments in their hulls, which are well battered and corroded within five to ten years, must be depreciated over ~~20~~ 15 years as to the barge hulls, and over ~~15~~ 10 years as to the tugboat hulls, as the courts below held, rather than over 10 or 12 years.

A thoroughgoing engineering study by the Government's own expert engineers (Ptlfs. Ex. 2) established that the correct reasonable period for depreciation was 10 to 12 years.

The precise issue, strictly speaking, is not how long a boat will live. The exact issue is not even necessarily "how long a hull will last," because factors such as obsolescence, inflation, business uncertainty and other reasons may indicate that a higher rate of depreciation is reasonable. Actually, where there is any substantial doubt at all, a depreciation rate should not be considered unreasonable where it does not substantially distort a true reflection of income. Thus, a depreciation write-off for machinery and equipment spread over 5 years should in most cases be all right,[3] and here the taxpayers are asking for a period twice that long.

This is so because reasonableness is the sole statutory standard. A "reasonable" allowance for depreciation is one that is "just, fair and equitable." 4 Mertens, Law of Federal Income Taxation (Rev.), Sec. 23.17.

Thus, the issue is simple. Even so, the Government and the courts below "missed the boat" in this respect in failing to recognize that "if each part [of a machine] is replaced as it wears out, at some point a new machine must be said to have replaced the original."[4]

Here the probable life of the hulls was so short that financial institutions would not lend money on the security of such equipment for more than 3 to 5 years.

Errors of law of courts below. The District Court fell into error because of the various arguments put forth by the Government.

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3. Cf. Report of the [Canadian] Royal Commission on Taxation (the Carter Report), Vol. 4, pp. 238-240 (1966).

4. Note, Amortization of Intangibles: An Examination of the Tax Treatment of Purchased Goodwill, 81 Harv. L. Rev. 859, 875 (Feb. 1968).

For example, the District Court used hindsight in its determination. Its findings of fact go into great detail as to the ages of various vessels as of the time of trial, 1966, approximately 8 years after most of the vessels involved were built.[5] In the very recent case of *Western Terminal Co. v. United States* (9th Cir., decided May 29, 1969), ____F.2d____ (69-2 USTC ¶9446), it was held—with the Government's concurrence—that "hindsight" is not to be used in determining depreciation controversies.

There the court requested and received a letter from the Government's counsel to such effect, which reads in part as follows:

> *It is now the view of the Internal Revenue Service that "hindsight" should not be used in the resolution of depreciation cases.* Treasury Regulations on Income Tax (1954 Code), Section 1.167(b)-0-(a) provides:
>
> * * * The reasonableness of any claim for depreciation shall be determined upon the basis of conditions known to exist at the end of the period for which the return is made. * * *
>
> See also, *Johnson v. Commissioner* (62-1 USTC ¶9450), 302 F.2d 86 (C.A. 4th, 1962), certiorari denied, 371 U.S. 904. *The Service's current position*

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5. For example, most of the depreciation fact findings rely on hindsight. The depreciation findings (Nos. 1-21c) cover 20 pages (pp. 5421-41) in 20 AFTR 2d. The court's reliance on hindsight is evident in the majority of these pages. In Finding No. 3 (20 AFTR 2d, p. 5421), the District Court notes that: *"By date of trial* six vessels had been disposed of" [emphasis added.] On the next page (p. 5422), the "Age at Date of Trial of these cases" is shown in the next-to-last column of a table. So also, in regard to the vessels in suit, Finding No. 10 and the table on page 5428 reflect hindsight. See also Findings 19-20, which cover ten pages (5430-40), and Findings 21b and 21c (p. 5441) at the end of the depreciation findings.

is consistent with the foregoing Regulation and its cited opinion. [Emphasis added.]

This suggests that this case at least should be remanded to the Fifth Circuit for reconsideration, in light of this recent concession by the Government.

The Government also led the District Court into error by placing heavy reliance on past history, contrary to the policy statement of the Secretary of the Treasury (Dillon) in 1962 that "The rate of depreciation * * * will not be tied to past history." (Pltfs. Ex. 2, p. 9, R. 1474.)

A Short History of Our Depreciation Law

In the early years of the income tax law the depreciation rules were extremely simple. The Government assumed that a businessman could best judge how long his machinery and equipment would be useful. The depreciation period generally was left up to the businessman to determine for himself, as long as he was consistent.

Things went smoothly until 1934. Then, by administrative action only, the Treasury Department, in an attempt, not to collect more revenue, but to collect it faster, began to press for lower depreciation rates.

At first, the Treasury merely required businessmen to prove that their depreciation rates were realistic. But in 1942 it completed the onerous task of setting down "realistic" rates for just about everything—mirrors, bookcases, rescue helmets and water coolers, as well as more vital factory equipment.

These rates were not compulsory. A businessman could try to negotiate with the Treasury Department for another

rate. But most smaller companies allowed the Treasury to call the tune.

Hardly anyone was pleased with the situation. In the post-World War II years the pace of technology's advance accelerated. Equipment that might not wear out for 15 years could easily become obsolete in seven.

In 1962 the Kennedy Administration took the complaints into account and eased the depreciation rules somewhat. Furthermore, it simplified things considerably; industrial equipment was grouped into various categories instead of being listed item-by-item.

A faster write-off reduces current taxes. Yet if a taxpayer continues to use the equipment his tax payments in later years will rise to make up the difference. And if he sells a fully depreciated machine he will have to pay ordinary-income taxes on the full sale price. So, since 1962, there is no tax variation. (See footnote 60, page 77, of our main brief in the Fifth Circuit.)

The importance of this case lies in the fact that the decision of the courts below is contrary to (1) the view of the Supreme Court and (2) the Government's own present policy, as the following discussion shows:

(1) *The Supreme Court's view.* In the U. S. Supreme Court's decision in the case of *United States v. Ludey*, 274 U.S. 295, 302, 71 L.Ed. 1054, 47 S.Ct. 608, 610 (1927), and subsequent cases, it was established that only a "rough estimate" is required for depreciation or cost-depletion purposes. This makes good sense because there figures to be no difference at all, tax-dollar-wise, whether depreciation is spread over a long or a short period.

(2) *National Treasury Department Policy.* The courts below gave no consideration to the fact that national Treasury Department policy supports the taxpayers' position: See e.g., Rev. Rul. 90, 1953-1 Cum. Bull. 43 (Appellants' Brief, Appendix A, at pp. 9-10). National Treasury policy supports the taxpayers because such policy supports:

a. generally not disturbing a taxpayer's depreciation (since "there may be reasonable differences of informed judgment," *ibid.*); and

b. depreciation over a reasonably short period (*ibid.*; see also T.I.R. No. 517 and Introduction to Rev. Proc. 62-21, Appellants' Brief, Appendix A, pp. 11-16).

The national office of the Treasury Department and the Internal Revenue Service recognize that there is no tax-dollar loss to the Treasury in this approach, but that, if it is not followed, modernization is seriously discouraged. This is a highly important fact. And its discriminatory effect here is patent.

Indeed, the Internal Revenue Service in 1966 amended its 1962 guidelines so as to specify a depreciation write-off over 12 years for floating oil barges used in offshore operations.[6] In this case some of the taxpayers' oil barges were used offshore, and in any event the undisputed evidence established that their inshore operations in narrow, shallow, winding channels were, if anything, harder on their hulls than offshore operations were. The record in this

6. Rev. Proc. 66-18, 1966-1 Cum. Bull. 646 (P. 16 of App. A of Appellants' Brief in 5th Cir.)

case reveals that depreciation periods of 10 years (or less) for comparable equipment are generally used by other operators in the Gulf Coast area (R. 1432), and it is now a matter of record that depreciation of such vessels over a 10-year period was sanctioned recently by the Internal Revenue Service, which "agreed that the method of depreciation urged by [the taxpayer—i.e., 10 years] * * * is approprate."[7] These taxpayers cannot effectively compete if they are discriminated against.

The Effect of Inflation

Actually, from the standpoint of economic reality, it is a fact—really incontestable—that inflation alone justifies the taxpayers' claim for a ten-year write-off.

We have had the federal income tax for over 50 years. Inflation has been continuously on the upswing for 30 years. The value of a dollar today is less than half what it was 20 years ago. We know of no authority for the proposition that inflation can never be considered for any taxing purposes. Inflation should not be ignored for purposes of determining reasonable depreciation for property held a decade or two. For the result of ignoring inflation will be that a tax supposedly on net profit is imposed instead on capital cost. This produces a discriminatory inequity. The inflation issue should not have been swept under the rug.

Quantum of Proof Required

The courts below erroneously failed to consider the factor of obsolescence—contrary to the law, the Regu-

7. *Tidewater Hulls, Inc. v. United States*, 68-1 USTC ¶9405 (E.D. La., 1968), *supra* (footnote 1 of opinion).

lations, national Treasury policy, and the evidence in this case. In *Burnet v. Niagra Falls Brewing Co.*, 282 U.S. 648, 655, 51 S.Ct. 262, 265, 75 L.Ed. 594, 598 (1931), the Supreme Court held:

> It would be unreasonable * * * to put upon the taxpayer the burden of proving to a reasonable certainty the existence and the amount of obsolescence. *Such weight of evidence as would reasonably support a verdict for a plaintiff in an ordinary action for the recovery of money fairly may be deemed sufficient.* * * * A reasonable approximation of * * * * * * [of obsolescence or wear and tear] * * * is all that is required. [Emphasis added.]

To require a higher standard of proof than a "rough estimate," fairly made, would be contrary to the Court's decision in *Ludey*, bad law, bad economics, contrary to present Treasury Department policy, and discriminatory.

REASONS FOR GRANTING THE WRIT

Preliminary Statement. We are concerned with two issues, a depreciation issue and a separate-corporations issue. A final decision has not been reached on the separate-corporations issue, pursuant to the Court of Appeals' reversal and remand to the trial court. Thus, this Court may well deem our petition premature as to the separate-corporations issue. Accordingly, this discussion will emphasize the importance of the depreciation issue.

The Supreme Court exists primarily to give a uniform and national interpretation to the constitution and the national laws. Here it seems that we may have a conflict between the courts, on the one hand, and the Treasury Department and perhaps Congress, on the other hand.

The issues presented are of broad, general importance.

To uphold the courts below on the depreciation issue will seriously and adversely affect the nation's entire economy. Repeal of the 7% investment credit now is probably wise because it represents an outright subsidy for capital-goods expansion, and the economy is presently overheated. But we should not go all the way to the other extreme, as the lower courts' decision would do. It really should not matter much whether depreciation is taken over a long term or a short term, as long as it does not result in a substantial distortion of the annual income picture. In this connection, a five-year spread ought to be sufficient as indeed it has been in the eyes of Congress when Congress has seen fit to provide for a depreciation span for capital expenditures that may have a much longer life.[8] Requiring too-long depreciation obviously discourages not merely expansion, but even the capital-goods spending necessary just to keep one's equipment safe and competitive. It discourages investment and modernization, and jeopardizes efficiency. To decide this issue in favor of the taxpayers can mean no loss in revenue and can hurt no one. To let the decisions of the lower courts stand will seriously hurt the nation's entire economy.

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8. The Government itself, when it has had occasion to authorize amortization or depreciation of an asset that actually has an unlimited life, has considered a 5-year spread as sufficient to avoid income distortion. See, for example: (1) Sec. 248 of the Revenue Code, which authorizes depreciation or "amortization" of corporate-organization expenses over a minimum period of 5 years; (2) Sec. 174(b), dealing with research and experimental expenditures, which provides that, if not currently deducted under Section 174(a), a taxpayer may elect to depreciate or amortize such expenditures over a period of 5 or more years, and (3) Sec. 177, containing a similar optional 5-year minimum depreciation (amortization) provision for trademark and trade name expenditures.

The decision of the courts below is contrary to the present national policy of the Treasury Department and the Internal Revenue Service, which favors giving taxpayers a presumptively free hand to set new, shorter-term depreciation rates—until such future time as they have proven wrong.

And the decision of the lower courts contravenes the decisions of this Court in *United States v. Ludey* and *Burnet v. Niagra Falls Brewing Co., supra.*

At issue is our whole approach to depreciation of personal property. Certiorari should be granted. Our economy is at stake.

CONCLUSION

For the reasons set forth, this petition should be granted.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing Petition for Writ of Certiorari have been served on the United States by airmailing, with postage prepaid, on this the ____ day of August, 1969, the same to the following:

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APPENDIX

Statutes Involved

Internal Revenue Code of 1954:

Section 167. *Depreciation.*

(a) *General Rule.* There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

(b) *Use of Certain Methods and Rates.* For taxable years ending after December 31, 1953, the term "reasonable allowance" as used in subsection (a) shall include (but shall not be limited to) an allowance computed in accordance with regulations prescribed by the Secretary or his delegate, under any of the following methods:

(1) the straight line method.

(2) the declining balance method, using a rate not exceeding twice the rate which, when added to all allowances for the period commencing with the taxpayer's use of the property and including the taxable year, does not, during the first two-thirds of the useful life of the property, exceed the total of such allowances which would have been used had such allowances been computed under the method described in paragraph (2).

Nothing in this subsection shall be construed to limit or reduce an allowance otherwise allowable under subsection (a).

(c) *Limitations on Use of Certain Methods and Rates.* Paragraphs (2) (3), and (4) of subsection

(b) shall apply only in the case of property (other than intangible property) described in subsection (a) with a useful life of 3 years or more * * *

(d) *Agreement as to Useful Life on Which Depreciation Rate is Based.* Where, under regulations prescribed by the Secretary or his delegate, the taxpayer and the Secretary or his delegate have, after the date of enactment of this title, entered into an agreement in writing specifically dealing with the useful life and rate of depreciation of any property, the rate so agreed upon shall be binding on both the taxpayer and the Secretary in the absence of facts or circumstances not taken into consideration in the adoption of such agreement. The responsibility of establishing the existence of such facts and circumstances shall rest with the party initiating the modification. Any change in the agreed rate and useful life specified in the agreement shall not be effective for taxable years before the taxable year in which notice in writing by certified mail or registered mail is served by the party to the agreement initiating such change.

Section 269. *Acquisitions Made to Evade or Avoid Income Tax.*

(a) *In General.*—if—

(1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

(2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the

hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation,

and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary or his delegate may disallow such deduction, credit, or other allowance. For purposes of paragraphs (1) and (2), control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation. * * *